ASSOCIATION OF CONSULTING ACTUARIES

Association of Consulting Actuaries Limited · First Floor (129) · 40 Gracechurch Street · London · EC3V 0BT
Tel: +44 (0)20 3102 6761 · Email: acahelp@aca.org.uk · Web: www.aca.org.uk

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pensions.investment@dwp.gov.uk

To the DC Policy, Investment and Governance Team

## Consultation on Enabling Investment in Productive Finance

I am writing on behalf of the **Association of Consulting Actuaries** in response to the above consultation. Our answers to your specific questions are set out in the **Appendix** to this letter.

We are encouraged to see the Government responding to industry feedback in relation to supporting defined contribution (DC) scheme investment in productive finance. However, we highlight that the charge cap itself has not to date been the only barrier. Larger DC arrangements (including master trusts and large own-trust schemes) are the most likely to introduce these asset classes, given the knowledge and governance required to manage and understand these more complex investments. These schemes are unlikely to be operating at fee levels anywhere near the charge cap. A package of measures will be required in order to further support the potential opportunity.

Note too that the proposals aimed at enabling investment in productive finance apply to both traditional money purchase schemes and to collective money purchase schemes (as set out in the Pension Schemes Act 2021 and also known as Collective Defined Contribution or “CDC” schemes). In our view, enabling investment in these assets is, if anything, an even more significant issue for CDC schemes. This is because CDC schemes can hold these assets over longer time horizons than individual DC savers would be able to do. In addition, as CDC schemes are likely to be larger than typical traditional own trust DC schemes, they are likely to be well placed to invest in a wide range of assets, including illiquids, which may be less attractive to smaller schemes. By pooling assets and offering target (not guaranteed) pensions, CDC schemes are well placed to seek investment returns through investing in different types of assets. In short, there seems to be a natural alignment between illiquid assets offering higher returns and CDC schemes, provided the charge cap is sufficiently flexible.

We trust that you find the contents of this letter of assistance. We would be happy to discuss them further if that is helpful. In that event, please contact me on 07557 031198 or at tessa.page@mercer.com.

Yours sincerely

**Tess Page,** Chair, DC Committee
**Vanessa Hodge,** Chair, Investment Committee
On behalf of the Association of Consulting Actuaries Limited

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# ACA response to the Consultation on Enabling Investment in Productive Finance

## Specific consultation questions

### 1a. Would adding performance-based fees to the list of charges which are outside the scope of the charge cap increase your capacity and appetite, as a DC scheme, to invest in assets like private equity and venture capital? Are you already investing in assets like private equity and venture capital, and if so would this change increase how much you invest? If you do not currently invest in such assets would this change make it more likely for you to, and do you have an idea of to what % of AUM that might be?

This would help to deal with the charge cap barrier, and with reporting for the Chair's Statement (as the relevant calculations would be less complex). However, the change would not address other issues relating to performance fees – notably:

- Fair allocation of costs to members investing over different periods (the issue being that because the performance fee amount is not known until after the fact and is applied retrospectively, this causes issues as members are free to move their assets in and out of funds, retire or transfer out. How do governance bodies ensure members pay for the performance they receive, or to what extend do you need to account for an individual member's experience?)
- Might certain groups be disadvantaged, for example new members joining after a good performance period paying higher fees despite not having enjoyed the returns.
- Communications and how the various charges will all be explained to the member

We also have some concerns that this could potentially be counterproductive as it could reduce the bargaining power of DC schemes to demand alternatives to performance fees.

For DC schemes already investing in these asset classes (which are few) we do not consider that the change would materially alter the % allocated. Any fee increase would still need to be communicated to members and this can be both a psychological and strategic barrier (i.e., governance bodies would need to be satisfied that on a net of fees basis, performance would be meaningfully better with a higher allocation).

### 1b. Would adding performance-based fees from the list of charges which are outside of the scope of the charge cap incentivise private equity and venture capital managers to change their fee structures?

We consider that this is more likely to further embed performance fees as normal practice, although it should be noted that the current size of the UK DC market (and the likely "share" of assets that might be allocated to these types of investments) is not large relative to global private equity and venture capital markets, and as such any amendments to DC cost calculations within the charge cap are unlikely to have a significant impact on pricing.

At the margin, and for investment managers focused on sales to UK pension schemes, the change has the potential to shift the balance away from the flat charge towards performance element. This includes the potential for an investment manager to substantially reduce or even remove their headline fixed annual management charge and move most / all of their charges into the performance fee to be "charge cap compliant" (without necessarily improving value for members, depending on the structure in place and the actual performance).

It should also be noted that based on our dialogue with investment managers, fee structures are just one element that drives a reluctance to enter the UK DC market. Other factors cited include the requirement to have their funds hosted on investment platforms (with the operational requirements that brings) and the nature of the cashflows.

## 1c. If you do not believe that the proposal outlined in this consultation is the right solution to the barrier posed by the regulatory charge cap, what might be a more effective solution?

Our key point in relation to this question is that we do not believe that the charge cap in and of itself is the primary barrier. A more effective solution would be a package of measures that address the following issues:

- Practicalities around managing illiquidity, and the extent of work required with the administrator, platform provider (if relevant) and other parties to implement a fund. An example of the challenges wrought by less liquid funds was provided during 2020, when many pooled, daily priced property funds suspended trading owing to difficulties in valuing the underlying assets. This delayed retirement for some DC savers and resulted in governance burdens for trustee boards in identifying suitable "default" arrangements for the redirection of contributions. We do acknowledge that the introduction of the LTAF will go some way to addressing this, making it easier to have a liquid fund for a DC default which has an illiquid allocation within it.
- Availability of suitable, high quality vehicles in which to invest (particularly for schemes on platforms), which have a total cost (whether performance related or not) that trustees assess to be good value for the benefits provided.
- Practical challenges in how cashflows are managed during the various stages of private market investments (formation, investment, harvesting, and extension phases). Including impact of the J-Curve. There are a growing number of "evergreen" funds but these are not the norm in private markets.
- Variable knowledge levels on trustee boards, combined with a governance budget (in terms of both time and financial resources) that is already stretched thinly. Whilst less liquid assets could and should be part of the range of options available to DC schemes, it does not automatically follow that many trustee boards will see a risk/return benefit in going down this route.

## 2. How can we ensure members of occupational DC pension schemes invested in default funds are sufficiently protected from high charges, whilst adding the performance related element of performance fees to the list of charges outside the scope of the charge cap?

The new, more rigorous, requirements in relation to value for money assessments developed jointly by the FCA and the Pensions Regulator will help with this.

We believe that performance fees should still be assessed as part of value for money assessments annually, regardless of their inclusion / exclusion from the charge cap, in order to ensure that the arrangements in place provide good value.

That said, across our member firms, DC consultants do not report seeing many examples of schemes with excessive charges for their default funds. Indeed, the level of competition has prompted almost the opposite – a race to the bottom.

We also caution against a focus on high charges only (often the most measurable and easily benchmarked aspect) – net of fees performance, member servicing, and broader scheme quality should be assessed together. We support the new holistic value for money framework to assist with this.

### 2a. Do you have any suggestions for how we can ensure that the regulations ensure members are only required to pay fees when genuine realised outperformance is achieved?

It will be essential to have a consistent framework for calculation of performance-based fees (similar to the guidance on slippage-cost methodology that was provided for the calculation of transaction costs for reporting purposes) and it would be helpful for this to be set out in the regulations. The objectives should be to ensure both consistency and fairness at the member level. A daily accrued mechanism applied to unit-holdings could be used as a starting point.

A specific suggestion is that the hurdle rate in the calculations should be applied from the 'high-water mark', to ensure that members do not pay for recovery after a previous market dip.

We also highlight the issue noted in our response to question 1a regarding member time horizons for accruing the fee.

### 3. Which of these conditions should the government apply to the types of performance-based fees that are excluded from the list of charges subject to the charge cap? Are there other conditions we should consider? If supported by guidance on acceptable structures would this give confidence to more schemes?

We consider the list of conditions to be comprehensive. However, the range of considerations highlights the complexity associated with performance fees (the terminology alone will be new to some trustees) which in itself may well prove to be the bigger barrier to confidence.

### 4: Do you agree with our proposal to require disclosure of performance fees if they are outside the scope of the charge cap? If so, we propose this is done in a similar way to transaction costs – do you agree? Could you provide details of any new financial costs that could arise from a requirement to disclose performance fees? Please outline any one-off and ongoing costs.

We agree that these fees should be disclosed. However, we do not believe that a similar approach to that taken for transaction costs is appropriate. Transaction costs under the current regime are buried within a lengthy Chair's  Statement, which few members read or are able to interpret. For those who do, it is likely they will be reading it having already been invested in their scheme rather than before making investment choices. Our strong preference would be for costs and charges reporting, including performance related fees, to be part of a more accessible document such as fund factsheets and the scheme investment guide.

It is also very difficult to disclose in a similar way to transaction costs because an "if they are paid" and an "if they are not paid" scenario would need to be considered, which doubles the number of already numerous projections required. Future investment return assumptions would also need to be considered – i.e. how should trustees determine future returns and whether a fee is payable or not?

### 5a: If we add performance fees to the list of charges which are not subject to the charge cap, do you agree that we should remove the performance fee smoothing mechanism and the pro-rating easement from the Charges and Governance Regulations 2015?

We are encouraged that the Government is prepared to take this step, having acknowledged the recommendations of the Productive Finance Working Group.

We are though somewhat surprised to see that recent proposals to allow for a smoothing of costs over a five year period could be abandoned, before they have had time to embed and assess the impact. However, if the proposal for the removal of performance fees from the charge cap goes ahead, we agree that the smoothing mechanism should be removed in order to provide consistency under the new approach.

### 5b: Is there a need for transitional protection arrangements to be brought in for schemes that have decided to make use of the performance fee smoothing mechanism, and if so what do these transitional arrangements look like?

Our understanding based on the schemes our member firms work with is that the smoothing mechanism has not been widely adopted. However, a reasonable window for any changes (we would suggest 18 months to allow a full year disclosure cycle to pass) would give relevant schemes time to prepare.

We would be happy to discuss these issues further if that is helpful. In that event, please contact me on 07557 031198 or at tessa.page@mercer.com.

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